VZCZCXRO4785
RR RUEHCN RUEHGH
DE RUEHGH #0023/01 0220737
ZNR UUUUU ZZH
R 220737Z JAN 10
FM AMCONSUL SHANGHAI
TO RUEHC/SECSTATE WASHDC 8496
INFO RUEHBJ/AMEMBASSY BEIJING 3263
RUEHCN/AMCONSUL CHENGDU 2356
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHGZ/AMCONSUL GUANGZHOU 0813
RUEHHK/AMCONSUL HONG KONG 2528
RUEHLO/AMEMBASSY LONDON 0063
RUEHML/AMEMBASSY MANILA 0151
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHFR/AMEMBASSY PARIS 0042
RUEHUL/AMEMBASSY SEOUL 0653
RUEHSH/AMCONSUL SHENYANG 2347
RUEHGP/AMEMBASSY SINGAPORE 0315
RUEHIN/AIT TAIPEI 2145
RUEHKO/AMEMBASSY TOKYO 0864
RUEHGH/AMCONSUL SHANGHAI 9163

UNCLAS SECTION 01 OF 04 SHANGHAI 000023

SENSITIVE
SIPDIS

DEPT FOR EAP/CM
NSC FOR MEDEIROS, LOI, SHRIER
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
USDOC FOR ITA DAS KASOFF, MELCHER, SZYMANSKI, MAC/OCEA
TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP
TREASURY FOR IMFP -- SOBEL/CUSHMAN
STATE PASS CEA FOR BLOCK
STATE PASS CFTC FOR OIA/GORLICK
MANILA FOR ADB USED
PARIS FOR US/OECD

E.O. 12958: N/A
TAGS: ECON EFIN EINV PGOV CH
SUBJECT: CHINA CAUTIOUS ON DERIVATIVES, SHUTTING OUT FOREIGN BANKS

REF: A. A) 09 SHANGHAI 401
¶B. B) 09 SHANGHAI 185

¶1. (SBU) Summary: Chinese government regulators remain generally cautious of introducing new derivatives products in China, and some continue to seek to restrict products previously offered by foreign-invested banks. Foreign banks remain largely shut out of the market for foreign exchange swaps and interest rate swaps. Foreign banks are also disappointed with progress so far on granting them permission to trade and underwrite Chinese corporate bond offerings. End Summary.

==========
Background
==========

¶2. (SBU) Visiting Treasury Department International Economist Benjamin Cushman met with several Shanghai-based contacts on China's derivative markets December 15-16. These included Frank Sirna, chief financial officer, and Paulus Mok, head of markets and country treasurer, Citi China; Zhang Xiaogang, R&D head, China Financial Future Exchange (CFFE); Chao Kejian, head of the Offering & Listing Department, Shanghai Stock Exchange; David Liao, managing director and head of global markets, HSBC China; Racky Shum, executive director, credit & rates markets, China, and head of rates trading, J.P.Morgan Chase China; and Raymond Yin, executive director, Gaohua Securities (a joint venture with Goldman Sachs).

¶3. (SBU) Chinese banks on September 16 began requiring foreign-invested locally incorporated banks to supply guarantees from their parent bank holding companies as a precondition to signing a new version of a derivatives trading "master agreement". (See ref A.) The new request from Chinese banks

came against a backdrop of increased caution on the part of both Chinese regulators and Chinese banks regarding the riskiness of counterparties and of derivative products. Few foreign banks supplied a parent-company guarantee by the deadline for concluding the new master agreements. Also in September, China's State-Owned Assets Supervision and Administration Commission (SASAC) announced that it would support Chinese state-owned companies wishing to renege on what SASAC described as improper derivatives contracts. Starting in spring 2009, many foreign firms have expressed concern regulators are moving slowly on opening the Chinese corporate bond market. (See ref B.)

==
Regulators Remain Cautious on Derivatives
==

¶4. (SBU) Chinese government regulators remain generally cautious about introducing new derivatives products in China, and some continue to seek to restrict products previously offered by foreign-invested banks. A Chinese financial official noted that the Central Government is still focused on implementing the economic stimulus package and assuring growth, and has no time to develop derivatives markets. A manager in a foreign-invested locally incorporated bank said that regulators are pushing back timetables for new products in the aftermath of the financial crisis. Several noted that Chinese retail investors do not understand the risks of the market, and regulators are taking time to build in protections for them.

¶5. (SBU) CFFE officials said that top Chinese leaders still have not given the go-ahead for what is expected to be the exchange's first product -- stock market index futures -- after

three years of mock trading. (Note: On January 8, Chinese media reported that the State Council has endorsed in principle the launch of stock index futures, with regulators suggesting final preparations could take three months. End note.) Since the financial crisis broke out, CFFE has been developing "investor suitability regimes" that weed out unsophisticated retail investors and attract institutional investors. CFFE officials were concerned that investors would be unable to distinguish the differences between a futures contract and a share. Investors will probably have to demonstrate a significant net worth (at least RMB500,000 to invest), pass a test on futures trading, and first participate in mock trading. In addition, investors will most likely be required to put down a 12 percent margin on trades, rather than the 10 percent previously considered.

¶6. (SBU) Several contacts commented on a newly proposed clearinghouse for spot currency trades and over-the-counter (OTC) derivative deals, which regulators hope will provide better information on exposures among market players. One Chinese financial official said the clearinghouse is being pushed by the People's Bank of China (PBOC), and shareholders will include the China Foreign Exchange Trading System (CFETS -- a PBOC-sponsored platform for foreign exchange trading, RMB lending and bond trading, and other financial transactions), the Ministry of Finance (MOF), and China Government Securities Depository Trust & Clearing Co., Ltd. (a clearinghouse for bonds established by PBOC and MOF). However, details remain sparse. Another noted the difficulty of posting OTC transactions on CFETS, since the frequently one-off OTC deals can't be quantified according to the usual standards; also, public posting leads to copycatting that drives down profit margins.

== =====
Stand-Off on Derivatives Master Agreements Continues
== =====

¶7. (SBU) Foreign-invested locally incorporated banks remain largely shut out of the market for foreign exchange swaps and interest rate swaps, say our contacts. Several point to Bank of

China (BOC) as the source of the difficulties, since BOC was "burned" on several foreign exchange deals and has the largest forex exposure of the major Chinese banks. For instance, BOC held off signing any bilateral bank-to-bank agreements on the terms of derivatives trades (known as a "master agreement") until the deadline of September 16, 2009, and on that day signed with several -- all Chinese banks. Some foreign bankers pointed to a related, but more systemic, problem: Chinese banks, including BOC, are not adept at handling collateral that foreign-invested banks are willing to use to backup their derivatives trades.

¶8. (SBU) While foreign-invested locally incorporated banks are not able to carry on derivatives trades as before, our contacts hold different perspectives on how this impacts their bottom line. One foreign banker asserted derivatives trading is down by 30 percent since the September 16 deadline passed. Another said liquidity in the market is down, and hedging is more expensive, but that since the renminbi exchange rate has remained pegged to the U.S. dollar in recent months, part of the drop off in transactions reflects less need for hedging. Two contacts pointed out that transaction volume may actually be as high or higher than previously because foreign banks are using "bridge banks" -- smaller local banks with which they have signed master agreements -- and therefore more transactions are

recorded to complete each deal. A third foreign banker noted that the onshore market in China is tiny compared to the offshore market, where Chinese banks continue to deal derivatives with foreign banks even without a master agreement.

¶9. (SBU) An executive at one foreign-invested locally incorporated bank said that resolving the derivatives master agreement issues is the "critical, number one issue to be resolved in 2010." Several noted that discussion will be taken up by the National Association of Financial Market Institutional Investors (NAFMII), a nominally self-regulatory industry body that is a spin-off from the PBOC. Two contacts said that the China Banking Regulatory Commission (CBRC) has been very supportive of a resolution. In the end, said one foreign banker, market demand for hedging instruments may play the crucial role.

=== ======
Threats to Renege on Derivatives Contracts Receding
=== ======

¶10. (SBU) SASAC in September 2009 stirred up concerns that it was encouraging state-owned enterprises (SOEs) to refuse to pay when derivatives contracts turned against them, but our contacts now see little chance that this will happen. Several contacts pointed to a November 30 speech by SASAC Vice Chairman Li Wei as helping to calm the waters. That said, SOEs are clearly becoming more cautious about taking on risky derivatives, with one banker with a major foreign-invested derivatives player saying his bank had not written a structured deal in six months. Another foreign banker said that he would not be surprised, however, if one or two SOEs reneged on a derivatives contract because the contract was entered into irregularly. (Note: According to Chinese regulations, a person signing a derivatives contract on behalf of a corporation must have proper authority from the company's board of directors, the derivative must fit into the company's overall risk-management strategy, and the hedge must be used in a real transaction. End note.)

¶11. (SBU) Our contacts pinned blame on both the banks and the firms involved in the derivatives contracts for some unadvisable deals. Chinese companies were taking on more risk because they saw only profits for several years, said several contacts. In some cases, firms were doubling or tripling down on their bets, hoping to make even greater gains. When the market turned, the profits evaporated and firms were in over their heads because some unscrupulous deals allowed for unlimited losses by the firms. "There were a lot of inappropriate trades," said a banker with one major foreign player. At the same time, another

foreign banker noted that now some of the problem contracts turned profitable again for the SOEs in December, and they have since stopped complaining. (Note: One foreign banker said that if the yen falls below 88 to the U.S. dollar, many SOEs who have signed derivatives contracts betting it would stay above 88 would begin to lose large amounts of money. End note.)

=== ===
Foreign-Invested Banks Blocked from Bond Trading
=== ===

¶12. (SBU) Foreign-invested locally incorporated banks are disappointed with progress so far on granting them permission to underwrite Chinese corporate bond offerings on the interbank market. Blame is placed on NAFMII, which has been sitting on the implementing rules for underwriting corporate bonds since early this year. One foreign banker says NAFMII -- which is

composed of industry players -- is seeking to limit competition. While two foreign-invested banks are represented in NAFMII, representatives of these banks say they are outvoted by the domestic NAFMII members when it comes to expanding the number of competitors allowed into the bond underwriting market. Several of our foreign banking contacts affirm they are eager to get into this potentially lucrative segment.

¶13. (SBU) Meanwhile, approval for foreign-invested banks to underwrite financial bonds is required from the PBOC Financial Markets Division, said one foreign banker, and the criteria for such approval remains unclear. HSBC has participated in a financial bond offering, but the circumstances may not be applicable as a precedent. Our HSBC contact says HSBC was a sub-underwriter on the bond issue of Bank of Shanghai, in which HSBC has investments; given this close corporate tie, HSBC applied to the lead underwriter, Industrial and Commercial Bank of China (ICBC), and ICBC accepted. Thus, the regulatory issue still has not been fully resolved at PBOC. CBRC, on the other hand, has recently taken a more open stance, according to our contacts, in particular Li Fuan, head of the banking innovation supervision department.

=======
Comment
=======

¶14. (SBU) The go-slow approach Chinese financial regulators are taking on derivative products is a predictable, and in some ways understandable, reaction to the turmoil in Western financial markets. For Chinese regulators, the connection is clear -- in his November 30 speech, SASAC vice chairman Li Wei states categorically that "The high leveraging of financial derivatives is a direct cause of the U.S. subprime loan crisis developing into a global financial crisis." However, both Chinese and foreign-invested financial institutions point out that hedging to facilitate business transactions is useful, while speculative hedging is more like gambling. In order to help advance the national goal of building Shanghai into an international financial center by 2020, the Shanghai Stock Exchange, for instance, needs to offer foreign investors a simple stock index future. At present, the CBRC appears to be on the side of further market opening, while NAFMII and to a lesser extent PBOC, are slowing progress.

¶15. (SBU) The Department of Treasury has cleared on this cable.
CAMP